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Proposed revisions to bank supervision guidelines seek to strengthen risk management

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In June 2008, the FSA published proposed revisions to its comprehensive guidelines for bank supervision. The revisions would strengthen risk management regulations in accord with Financial Stability Forum recommendations. They call upon top management to improve risk governance and charge risk management staff with the mission of global oversight and development of more sophisticated modeling capabilities.

The Financial Stability Forum's (FSF) Working Group on Market and Institutional Resilience unveiled a set of recommendations at the April 2008 meeting of G7 finance ministers and central bankers. In response, Japan's Financial Services Agency (FSA) recently published proposed revisions to its Comprehensive Guidelines for the Supervision of Major Banks and Comprehensive Guidelines for the Supervision of Small/Medium-Sized and Regional Financial Institutions and solicited public comments on the revisions, which specifically pertain to risk management of complex financial instruments[1). Below we analyze[2) the proposed revisions' aims and discuss potential compliance approaches, focusing mainly on issues with the most significant implications for financial institutions' day-to-day operations.

Risk management issues addressed by guideline revisions

1) Improvement of risk governance

In terms of overall risk management, the proposed revisions would require financial institutions' top management to exercise stricter risk governance with respect to complex financial instruments.

The proposed revisions with the biggest ramifications for financial institutions are those related to market risk management. These provisions would require top management to be conversant with risk management. They would also demand broad analytical capabilities that encompass even overseas economic conditions. Financial institutions' capacity to independently develop such analytical capabilities is limited. Moreover, the issue of how much information to analyze remains to be resolved. As a first step in improving the adequacy of information analysis, financial institutions could ask originators to make more information available to them, though it is unlikely that many could readily do so.

2) Technical requirements for risk management

The proposed revisions include quite specific technical requirements for risk management procedures, but there are concerns that the requirements would be an onerous burden on financial institutions. One concern is a mandate to strengthen overall risk management inclusive of all group companies. Of particular concern is that the parent company's risk management staff would have to exercise oversight of overseas subsidiaries. To effectively do so, financial institutions would need risk management personnel with a global skill set and even greater proficiency in front-office operations than the current generation of risk managers.

Another concern is the need for ongoing research to upgrade internal models' sophistication. Meeting this requirement would entail development of quantitative assessment frameworks (e.g., model validity tests, stress-testing of underlying assumptions) and likely impose a heavy burden on smaller and regional financial institutions in particular.

For example, financial institutions would need to establish a monitoring cycle to assess models' validity (e.g., with respect to intermarket correlations). Equally important are basic testing capabilities, including model revision, in the event that monitoring reveals a major loss of statistical significance. It is doubtful, however, that many financial institutions now possess or could rapidly develop such capabilities.

3) Risk management of complex financial instruments

Another respect in which the FSA's proposed revisions

Exhibit. Overview of proposed revisions to bank supervision guidelines in response to FSF recommendations

Themes (as identified by author)		Proposed revisions	Applicable guidelines	
Theme	Subthemes		Major banks	Smaller / regional FIs
Overall risk management		Improvement of senior management's governance of risk management, particularly for financial products that pose complex risks	○	○
Credit risk				
	Liquidity enhancement	Requirements for managing the risk of having to provide liquidity enhancement	○	–
	Counterparty risk	Requirements for counterparty credit risk management	○	○
Market risk				
	Overall market-risk management	Increased involvement by senior management	○	○
		Improvement/expansion of information collection	○	○
	Risk management methods	Development of more sophisticated models	○	○
		Establishment of verification frameworks	○	○
		Detailed stress-test requirements	○	○
	Complex financial instrument risks	Product valuation requirements	○	○
		Requirements for ascertainment of product attributes	○	○
		Risk management requirements for market liquidity	○	○
		Risk management requirements for product structure, etc.	○	–

Source: "Proposed Revisions to Comprehensive Guidelines for the Supervision of Major Banks, etc." and "Comprehensive Guidelines for the Supervision of Small/Medium-Sized and Regional Financial Institutions, New-versus-Old Comparison Table" (selected revisions pertaining to risk management of complex financial instruments)

are highly significant is that they expressly prescribe risk management requirements for complex financial instruments. Given financial institutions' status quo, however, these requirements may be onerous. For example, they would require risk management staff to independently verify valuations calculated by the front office. Having in-house risk management staff ready to value all complex financial instruments as soon as the proposed revisions take effect would be a formidable challenge even for the major banks.

Financial institutions will have to learn through trial and error

In sum, financial institutions are being called upon to practice increasingly sophisticated risk management. However, the FSA's supervisory guidelines are strictly "principles" for financial institutions. It is important for financial institutions to flexibly incorporate these guidelines into their own day-to-day operations instead of treating them as rigid rules.

For example, to compensate for existing informational and skill deficiencies, financial institution should consider flexible options such as enhancing in-house capabilities while utilizing the expertise of third parties such as data vendors and specialized consultants. Whatever outside expertise they utilize, however, financial institutions need the ingenuity (e.g., verification techniques) to be able to assume ultimate responsibility themselves.

The FSA's proposed new supervisory guidelines cite examples of specific methods of gauging market liquidity[3], one of which is bid/offer spread inquiries. However, a heavy volume of casual inquiries could pose reputational risk. Financial institutions must exercise due discretion based on the recognition that the methods cited in the guidelines are merely examples.

In any event, the learning process of building effective risk management systems through repeated trial and error should prove beneficial for Japanese financial institutions.

Note

1) As used herein, "complex financial instruments" refers to all tradable, asset-backed financial products.

2) Although the FSA prescribes separate Comprehensive Guidelines for major banks and for small/medium-sized and regional financial institutions, our discussion herein pertains to both unless expressly noted otherwise.

3) The guidelines cite the following four specific methods: (1) comparing the size of one's holdings of a given asset with the overall market's size to determine whether the holdings constitute an excessive share of the market, (2) ascertaining market bid/offer spreads and/or actual salable prices through contacts with market participants, (3) monitoring changes in the market environment through analysis of market indices, etc., and (4) stress-testing securitized portfolios under hypothetical illiquid-market scenarios based on historical stress events.

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